

Legislative Audit Division

State of Montana



Report to the Legislature

November 2004

Financial-Compliance Audit For the Two Fiscal Years Ended June 30, 2004

State Auditor's Office

This report contains six recommendations to the office related to:

- ▶ Insurance examiner conflict of interest
- ▶ Insurance company assignment of deposit requirements
- ▶ Accurately recording financial information on the state's accounting system

Direct comments/inquiries to:
Legislative Audit Division
Room 160, State Capitol
PO Box 201705
Helena MT 59620-1705

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FINANCIAL-COMPLIANCE AUDITS

Financial-compliance audits are conducted by the Legislative Audit Division to determine if an agency's financial operations are properly conducted, the financial reports are presented fairly, and the agency has complied with applicable laws and regulations. In performing the audit work, the audit staff uses standards set forth by the American Institute of Certified Public Accountants and the United States Government Accountability Office. Financial-compliance audit staff members hold degrees with an emphasis in accounting. Most staff members hold Certified Public Accountant (CPA) certificates.

Government Auditing Standards, the Single Audit Act Amendments of 1996 and OMB Circular A-133 require the auditor to issue certain financial, internal control, and compliance reports. This individual agency audit report is not intended to comply with these reporting requirements and is therefore not intended for distribution to federal grantor agencies. The Legislative Audit Division issues a statewide biennial Single Audit Report which complies with the above reporting requirements. The Single Audit Report for the two fiscal years ended June 30, 2005, will be issued by March 31, 2006. The Single Audit Report for the two fiscal years ended June 30, 2003, was issued on March 23, 2004. Copies of the Single Audit Report can be obtained by contacting:

Single Audit Coordinator
Office of Budget and Program Planning
State Capitol
Helena MT 59620
Phone (406) 444-3616

Legislative Audit Division
Room 160, State Capitol
PO Box 201705
Helena MT 59620-1705

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November 2004

The Legislative Audit Committee
of the Montana State Legislature:


This is our financial-compliance audit report on the State Auditor's Office (office) for the two fiscal years ended June 30, 2004. Included in this report are recommendations concerning compliance with state law pertaining to conflict of interest for insurance examiners, custodial deposit assignments, and recording financial information on the state's accounting records. The office's written response to the audit recommendations is included in the audit report beginning on page B-3.

We thank the State Auditor and his staff for their assistance and cooperation during the audit.

Respectfully submitted,

A handwritten signature in dark ink, appearing to read "Scott A. Seacat", with a long, sweeping horizontal line extending to the right.

Scott A. Seacat
Legislative Auditor



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Legislative Audit Division

Financial-Compliance Audit

For the Two Fiscal Years Ended June 30, 2004

State Auditor's Office

Members of the audit staff involved in this audit were Pearl M. Allen,
John Fine, Hollie Koehler, and Sonia Powell.

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Elected and Administrative Officials

State Auditor's Office

John Morrison, State Auditor

David Hunter, Deputy State Auditor

Karen Powell, Deputy Securities Commissioner

Alicia Pichette, Deputy Insurance Commissioner

John Huth, Central Services Administrator

For additional information concerning the State Auditor's Office,
contact John Morrison at:

State Auditor's Office
PO Box 4009
Helena MT 59604-4009
(406) 444-2040

e-mail: jmorrison@state.mt.us

State Auditor's Office

This report contains the results of our financial-compliance audit of the State Auditor's Office (office) for the two fiscal years ended June 30, 2004. This report contains six recommendations directed to the office concerning compliance with state law pertaining to conflict of interest for insurance examiners, custodial deposit assignments, and recording financial information on the state's accounting records. An unqualified opinion on the office's financial schedules was issued, which means the reader may rely on the financial information and supporting data on the state's accounting records.

The listing below serves as a means of summarizing the recommendations contained in the report, the office's response thereto, and a reference to the supporting comments.

Recommendation #1

We recommend the office comply with state law by only appointing examiners that do not have a conflict of interest with the insurance company being examined. 6

Agency Response: Concur. See page B-3.

Recommendation #2

We recommend the office develop procedures to comply with the custodial deposit assignment requirements, as specified in state law. 7

Agency Response: Concur. See page B-4.

Recommendation #3

We recommend the office perform additional supervisory review of infrequent and year-end accounting transactions to improve the accuracy of the accounting records. 8

Agency Response: Concur. See page B-4.

Report Summary

| | | |
|--------------------------|--|----|
| <u>Recommendation #4</u> | We recommend the office work with the Department of Administration to record the financial activity and financial position related to the Surplus Lines Advisory Organization in the state's accounting records..... | 10 |
| | <u>Agency Response:</u> Concur. See page B-4. | |
| <u>Recommendation #5</u> | We recommend the office apportion forest reserve funds within 30 days of receiving final payment from the federal government, as required by state law..... | 11 |
| | <u>Agency Response:</u> Concur. See page B-5. | |
| <u>Recommendation #6</u> | We recommend the office follow up on local government audit findings communicated to the office, as required by federal law. | 12 |
| | <u>Agency Response:</u> Do not concur. See page B-5. | |

Introduction

General

We performed a financial-compliance audit of the State Auditor's Office (office) for fiscal years 2002-03 and 2003-04. The objectives of our audit were to:

1. Determine if the office complied with applicable laws and regulations.
2. Make recommendations for improvement in management, internal controls, and financial operations.
3. Determine if the office's financial schedules present fairly the results of operations for the two fiscal years ended June 30, 2004.
4. Determine the implementation status of prior audit recommendations.

This report contains six recommendations to the office. Other areas of concern deemed not to have a significant impact on the successful operations of the programs within the State Auditor's Office are not specifically included in the report, but have been discussed with management.

In accordance with section 5-13-307, MCA, we analyzed and disclosed the cost, if significant, of implementing the recommendations.

Office Background and Organization

The State Auditor's Office was established by Article VI, Section 1 of the Montana Constitution. The State Auditor is the ex-officio Commissioner of Insurance and the ex-officio Commissioner of Securities. The State Auditor licenses and regulates insurance companies and agents within the state, and regulates and registers securities dealers. The State Auditor also serves as a member of the State Land Board and the Crop Hail Insurance Board. Total full-time equivalent (FTE) positions of the office as of June 2004 are 71.5. The office currently has 13.0 exempt positions.

Introduction

The office is organized as follows:

1. The Central Management Division is responsible for the administrative, budgeting, personnel, and accounting functions of the office. The division also provides support for the State Auditor as he fulfills his duties on the State Land Board and the Crop Hail Insurance Board. (10.0 FTE)
2. The Insurance Division regulates the insurance industry in Montana. Its duties include resolving insurance consumer inquiries and complaints about agents, coverage, and companies; licensing and reviewing the rates and financial condition of insurance companies; collecting the insurance premium tax; approving forms used by insurance companies; licensing, testing, and administering a continuing education program for insurance agents; and investigating insurance code and rule violations. (48.5 FTE)
3. The Securities Division is responsible for the administration and enforcement of the Securities Act of Montana. The division is responsible for the registration of securities issuers, salespeople, investment advisers, broker-dealers, and investment adviser representatives. It also investigates instances of unregistered or fraudulent securities transactions. (13.0 FTE)

The office is responsible for distributing a portion of insurance premium taxes to the Montana Public Employees' Retirement Administration and to fire and police departments in qualifying Montana cities and towns. The office also distributes federal forest reserve moneys to Montana counties.

Prior Audit Recommendations

The prior financial-compliance audit of the office for the two fiscal years ended June 30, 2002 contained four recommendations to the office. During the current audit, we determined the office implemented one of the recommendations, partially implemented two recommendations, and did not implement one recommendation. One recommendation that was partially implemented dealt with recording the proper amount for additions and reductions to property held in trust and is discussed on page 7. The other partially implemented prior audit recommendation, pertaining to recording fees in the correct account, was substantially implemented by fiscal year end 2003-04, so we make no further recommendation at this

time. The recommendation not implemented deals with a stamping fee not recorded on the state's accounting records and is discussed on page 8 of this report.

Findings and Recommendations

Insurance Regulation

The State Auditor's Office (office) licenses and regulates insurance companies and agents within the state of Montana. As part of the office's regulation of Montana insurance companies, comprehensive examinations are performed for each new insurance company, and at least once every five years for existing companies.

Insurance Examiner Conflict of Interest

The office used a contract examiner who had a conflict of interest with the insurance company he examined.

The office currently employs two examiners, and one contract examiner, to perform insurance examinations. To maintain objectivity in the examinations performed, the office has established conflict of interest policies to help prevent an examiner from performing exams for companies in which he or she is affiliated with the management.

In addition, section 33-1-410(1), MCA, states an examiner may not be appointed by the commissioner (State Auditor) if he or she is affiliated with management or owns a pecuniary interest in any entity subject to the examination.

During our audit, we noted a conflict of interest that occurred during a fiscal year 2000-01 examination involving the contract examiner and a friend, who was employed as the insurance company's controller. The controller was a former employee of the State Auditor's office. The office was aware that the conflict existed, but did not have additional examiners available to perform the work. The examination was conducted, as scheduled, with an increased level of supervision over the examination process, in an effort to mitigate biases resulting from the contract examiner's affiliation with management.

The office is in the process of accepting bids from other contract examiners, who can perform insurance company examinations in the event a future conflict of interest occurs.

Findings and Recommendations

Recommendation #1

We recommend the office comply with state law by only appointing examiners that do not have a conflict of interest with the insurance company being examined.

Insurance Securities Not Assigned

The office is not in compliance with custodial deposit requirements.

The State Auditor's Office requires insurance companies transacting business in Montana to have on deposit with the office securities sufficient to protect policyholders in the event of company insolvency. Securities are held in custodial arrangements with trustee banks located in Montana. Section 33-2-606, MCA, requires all securities not negotiable by delivery to be assigned to the State Auditor and his successors in office.

The office periodically releases the securities on deposit to allow companies to update their investments or the amounts on deposit. The office does not have procedures requiring a new assignment be on file prior to releasing a security deposit.

The office currently holds over \$11 million in custodial securities under this statute. At the end of fiscal year 2002-03, approximately \$1.6 million of these custodial securities did not have an assignment with the State Auditor, as required by law. At the end of fiscal year 2003-04, there were approximately \$1.7 million in deposits not assigned. All of the unassigned securities at fiscal year-end 2003-04 had carried forward from fiscal year 2002-03, indicating the insurance companies were not prompt in their efforts to comply with custodial deposit requirements. Our prior audit, for the two fiscal years ended June 30, 2000, also recommended the office ensure all securities on deposit are assigned to the office.

Findings and Recommendations

Recommendation #2

We recommend the office develop procedures to comply with the custodial deposit assignment requirements, as specified in state law.

Accounting Errors

The office made errors in recording revenues, expenditures, and additions and reductions to property held in trust during fiscal years 2002-03 and 2003-04.

State law requires the office to input all necessary transactions before the end of the fiscal year to present the receipt, use, and disposition of all money and property for which it is accountable in accordance with generally accepted accounting principles. The Department of Administration establishes state accounting policy to implement this law. During the audit, we noted the following instances where the office did not record financial activity in accordance with state law and state policy. The activity discussed relates mainly to less frequent, or fiscal year-end, accounting entries.

- ▶ During fiscal year 2002-03, the State Auditor's Office received a \$500,000 settlement from a class-action lawsuit filed against Merrill Lynch. This settlement, deposited in the General Fund, was coded as licenses and permits revenue instead of fines and forfeits. Office personnel detected and corrected the error in fiscal year 2003-04.
- ▶ At fiscal year-end 2004, the office accrued expenditures of \$446,399 in the General Fund for the state's contribution to the Montana Police Officers' Retirement System and the Firefighters' Unified Retirement System. These accruals did not agree with the office's estimate of \$590,937 for these pension amounts.
- ▶ During fiscal year 2002-03, the office did not record entries to correct errors made to the property held in trust accounts in prior fiscal years. Additions and reductions to property held in trust entries were made for fiscal year 2002-03, but due to a clerical error, these amounts were posted to fiscal year 2003-04, instead of fiscal year 2002-03. Fiscal year 2003-04 additions and reductions to property held in trust were recorded in the incorrect

Findings and Recommendations

amounts, which overstated the ending property held in trust balance by \$33,208.

- ▶ During fiscal year 2003-04, the office did not record \$84,581 in costs associated with the Montana Comprehensive Health Association on its accounting records, understating expenditures for grants to local agencies, which is where this activity should be recorded.
- ▶ The security and insurance divisions receive reimbursement from companies for examinations performed by outside sources under contract with the State Auditor's Office. Currently, this revenue is coded as licenses and permits when it should be coded as charges for services.

The majority of these issues relate to accounting errors that were not identified prior to fiscal year-end close. Although the office currently has documented procedures for supervisory review of revenues, accruals, and other transactions, the review did not detect these errors. The review could be more effective in detecting errors by focusing on less frequent type of transactions and those that occur only at fiscal year-end.

Recommendation #3

We recommend the office perform additional supervisory review of infrequent and year-end accounting transactions to improve the accuracy of the accounting records.

Stamping Fees Not Recorded

The office did not record revenues and expenditures related to the Surplus Lines Advisory Organization, including the stamping fee authorized in section 33-3-321(5), MCA.

The Surplus Lines Advisory Organization is a separate, legal entity, which operates under the general supervision of the State Auditor's Office. Section 33-2-321, MCA, allows for the formation of this advisory organization, consisting of surplus lines insurance producers, for the purpose of facilitating and encouraging compliance by its members with the laws of the state and the rules of the State Auditor.

Findings and Recommendations

The State Auditor is charged with regulatory oversight of the insurance industry. The State Auditor has delegated a portion of his oversight responsibility to this advisory organization, which is organized:

- ▶ “To foster, protect, and promote the welfare, interest, and business of surplus lines producers...;
- ▶ To protect the interest of the insuring public; and
- ▶ To maintain liaison between producers and the Commissioner of Insurance of the State of Montana.”

Section 33-2-321(5), MCA, allows the Surplus Lines Advisory Organization to collect a stamping fee, set by the State Auditor, not to exceed 1 percent of the premium payable for surplus lines insurance. These revenues are used to pay expenses incurred in performing surplus lines regulatory activities, as described above. This statute also allows the State Auditor to perform examinations of this organization, compel membership in the organization, and to directly collect the stamping fee assessment, in the event the surplus lines organization is not fulfilling the requirements set forth in statute.

We recommended in our prior audit that the stamping fee activity, collected by the organization, be recorded on the state’s accounting records. During fiscal year 2003-04, the office contacted the Department of Administration (department) to establish accounts and funds to record this activity. The department responded that it did not agree with our audit recommendation. Department staff stated, “just because an entity must track the related activity and potentially return funds to the State at a later date does not make these assets or the related nominal activity reportable within the State’s accounting system. Also, the fact that the State may be able to take control of the entity in the future does not make the entity a component unit.” As a result of this disagreement, the State Auditor’s Office postponed recording this activity until its staff could work with the department to resolve questions pertaining to the office’s reporting requirements under generally accepted accounting principles.

Findings and Recommendations

We disagree with the department's position regarding our prior recommendation. The fiscal dependence of the advisory organization on the State Auditor's Office, and the regulatory oversight of the advisory organization by the State Auditor, as it pertains to surplus lines insurance activity, indicates a direct, financial relationship requiring the organization to be reported on the state's financial records. This criteria is established in Statement No. 39 of the Governmental Accounting Standards Board. Excluding this information from financial reporting requirements is misleading to the users of this information, since the stamping fees collected are directly related to the amount of surplus lines insurance oversight activity that has been delegated to the organization.

Recommendation #4

We recommend the office work with the Department of Administration to record the financial activity and financial position related to the Surplus Lines Advisory Organization in the state's accounting records.

Federal Forest Reserve Funds

The State Auditor's Office is the pass-through agency for the federal forest reserve program. This program distributes funds from the national forests to the states in which these forests are situated.

Delays in Forest Reserve Distribution

The office did not apportion forest reserve funds, and the associated interest earnings, in a timely manner, delaying the payments made to counties under this program.

Sections 17-3-211(1) and 17-3-212(1), MCA, require the office to apportion the forest reserve funds, and interest earnings, in time to allow funds to be distributed to counties within 30 days of receiving final payment from the federal government. During fiscal years 2002-03 and 2003-04, the office delayed apportioning the interest earnings, which delayed payments made to counties.

Staff indicated that they were not aware of the time requirements imposed under statute, and were also not aware that the investment

Findings and Recommendations

account needed to be closed prior to the distribution cycle. As a result, \$12,464,355 was distributed 18 days later than required by law in fiscal year 2002-03, and \$12,415,384 was distributed 10 days later than required by law in fiscal year 2003-04.

Recommendation #5

We recommend the office apportion forest reserve funds within 30 days of receiving final payment from the federal government, as required by state law.

Subrecipient Monitoring Requirement

The office did not comply with federal subrecipient monitoring requirements for counties receiving forest reserve funds.

As the pass-through agency for the federal forest reserve program, the office is responsible for monitoring the forest reserve funds disbursed to the counties under federal OMB Circular A-133 requirements. Local Government Services, a division of the Department of Administration, contracts with independent auditors to perform audits of counties. Findings conveyed in these audit reports are then communicated to each agency with responsibility for the program.

During fiscal year 2003-04, there were two findings related to the federal forest reserve program that were communicated to the office by Local Government Services. The office did not perform any follow-up on these communications.

Staff indicated that the office is required to distribute funds under state law and cannot withhold funds for non-compliance with either state or federal laws. Because the office lacks this capability, it does not follow-up on findings communicated from local government audits. We disagree with this response, since monitoring the forest reserve funds disbursed, by following up on local government audit findings, is required by federal law.

Findings and Recommendations

Recommendation #6

We recommend the office follow up on local government audit findings communicated to the office, as required by federal law.

Independent Auditor's Report & Office Financial Schedules

LEGISLATIVE AUDIT DIVISION

Scott A. Seacat, Legislative Auditor
John W. Northey, Legal Counsel



Deputy Legislative Auditors:
Jim Pellegrini, Performance Audit
Tori Hunthausen, IS Audit & Operations
James Gillett, Financial-Compliance Audit

INDEPENDENT AUDITOR'S REPORT

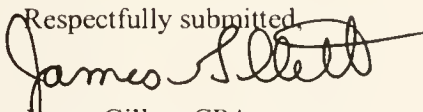
The Legislative Audit Committee
of the Montana State Legislature:

We have audited the accompanying Schedules of Changes in Fund Balances & Property Held in Trust, Schedules of Total Revenues & Transfers-In, and Schedules of Total Expenditures & Transfers-Out of the State Auditor's Office for each of the fiscal years ended June 30, 2004, and 2003. The information contained in these financial schedules is the responsibility of the office's management. Our responsibility is to express an opinion on these financial schedules based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial schedules are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial schedules. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial schedule presentation. We believe that our audit provides a reasonable basis for our opinion.

As described in note 1, the financial schedules are presented on a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America. The schedules are not intended to be a complete presentation and disclosure of the office's assets and liabilities.

In our opinion, the financial schedules referred to above present fairly, in all material respects, the results of operations and changes in fund balances and property held in trust of the State Auditor's Office for each of the fiscal years ended June 30, 2004, and 2003, in conformity with the basis of accounting described in note 1.

Respectfully submitted,

James Gillett, CPA
Deputy Legislative Auditor

August 6, 2004

STATE AUDITOR'S OFFICE
SCHEDULE OF CHANGES IN FUND BALANCES & PROPERTY HELD IN TRUST
FOR THE FISCAL YEAR ENDED JUNE 30, 2004

| | General Fund | State Special Revenue Fund | Federal Special Revenue Fund | Agency Fund |
|---|-----------------|-------------------------------|---------------------------------|----------------|
| FUND BALANCE: July 1, 2003 | | | | |
| PROPERTY HELD IN TRUST: July 1, 2003 | \$ (13,124,744) | \$ 3,169,220 | \$ 7,216 | \$ 0 |
| ADDITIONS | | | | \$ 11,853,555 |
| Budgeted Revenues & Transfers-In | 66,467,961 | 7,182,336 | 12,514,286 | |
| NonBudgeted Revenues & Transfers-In | 2,113,257 | 31,888 | | |
| Prior Year Revenues & Transfers-In Adjustments | (5,360) | 1,244 | | |
| Direct Entries to Fund Balance | (55,186,979) | 568,640 | | |
| Additions to Property Held in Trust | | | | 731,138 |
| Total Additions | 13,388,879 | 7,784,108 | 12,514,286 | 731,138 |
| REDUCTIONS | | | | |
| Budgeted Expenditures & Transfers-Out | 15,621,310 | 4,446,908 | 12,446,401 | |
| NonBudgeted Expenditures & Transfers-Out | | 2,129,709 | | |
| Prior Year Expenditures & Transfers-Out Adjustments | | 942 | (29) | |
| Reductions in Property Held in Trust | | | | 1,311,625 |
| Total Reductions | 15,621,310 | 6,577,559 | 12,446,372 | 1,311,625 |
| FUND BALANCE: June 30, 2004 | \$ (15,357,175) | \$ 4,375,769 | \$ 75,130 | \$ 0 |
| PROPERTY HELD IN TRUST: June 30, 2004 | | | | \$ 11,273,068 |

This schedule is prepared from the Statewide Accounting, Budgeting, and Human Resources System (SABHRS) without adjustment. Additional information is provided in the notes to the financial schedules beginning on page A-11.

STATE AUDITOR'S OFFICE
SCHEDULE OF CHANGES IN FUND BALANCES & PROPERTY HELD IN TRUST
FOR THE FISCAL YEAR ENDED JUNE 30, 2003

| | General Fund | State Special Revenue Fund | Federal Special Revenue Fund | Agency Fund |
|---|-------------------|-------------------------------|---------------------------------|----------------------|
| FUND BALANCE: July 1, 2002 | \$ (12,358,358) | \$ 2,303,584 | \$ 0 | \$ 0 |
| PROPERTY HELD IN TRUST: July 1, 2002 | | | | \$ 11,853,555 |
| ADDITIONS | | | | |
| Budgeted Revenues & Transfers-In | 56,094,502 | 6,358,833 | 12,478,757 | |
| NonBudgeted Revenues & Transfers-In | 2,037,286 | 19,754 | 50,256 | |
| Prior Year Revenues & Transfers-In Adjustments | (58,439) | (10,484) | | |
| Direct Entries to Fund Balance | (43,945,318) | (1,738) | | |
| Total Additions | <u>14,128,031</u> | <u>6,366,365</u> | <u>12,529,013</u> | |
| REDUCTIONS | | | | |
| Budgeted Expenditures & Transfers-Out | 14,894,242 | 3,455,200 | 12,521,797 | |
| NonBudgeted Expenditures & Transfers-Out | | 2,049,254 | | |
| Prior Year Expenditures & Transfers-Out Adjustments | 175 | (3,725) | | |
| Total Reductions | <u>14,894,417</u> | <u>5,500,729</u> | <u>12,521,797</u> | |
| FUND BALANCE: June 30, 2003 | \$ (13,124,744) | \$ 3,169,220 | \$ 7,216 | \$ 0 |
| PROPERTY HELD IN TRUST: June 30, 2003 | | | | <u>\$ 11,853,555</u> |

This schedule is prepared from the Statewide Accounting, Budgeting, and Human Resources System (SABHRS) without adjustment. Additional information is provided in the notes to the financial schedules beginning on page A-11.

STATE AUDITOR'S OFFICE
SCHEDULE OF TOTAL REVENUES & TRANSFERS-IN
FOR THE FISCAL YEAR ENDED JUNE 30, 2004

TOTAL REVENUES & TRANSFERS-IN BY CLASS

| | General Fund | State Special Revenue Fund | Federal Special Revenue Fund | Total |
|--|---------------------|----------------------------|------------------------------|-------------------|
| Licenses and Permits | \$ 5,534,487 | \$ 7,183,580 | | \$ 12,718,067 |
| Taxes | 55,327,220 | | | 55,327,220 |
| Investment Earnings | | | \$ 15,718 | 15,718 |
| Fines, Forfeits and Settlements | 5,600,914 | | | 5,600,914 |
| Miscellaneous | 237 | 31,888 | 23,606 | 55,731 |
| Other Financing Sources | 2,113,000 | | | 2,113,000 |
| Federal | | | 12,474,962 | 12,474,962 |
| Total Revenues & Transfers-In | 68,575,858 | 7,215,468 | 12,514,286 | 88,305,612 |
| Less: Nonbudgeted Revenues & Transfers-In | | | | |
| Prior Year Revenues & Transfers-In Adjustments | 2,113,257 | 31,888 | | 2,145,145 |
| | (5,360) | 1,244 | | (4,116) |
| Actual Budgeted Revenues & Transfers-In | 66,467,961 | 7,182,336 | 12,514,286 | 86,164,583 |
| Estimated Revenues & Transfers-In | 65,064,000 | 6,535,369 | 13,778,600 | 85,377,969 |
| Budgeted Revenues & Transfers-In Over (Under) Estimated | \$ 1,403,961 | \$ 646,967 | \$ (1,264,314) | \$ 786,614 |

BUDGETED REVENUES & TRANSFERS-IN OVER (UNDER) ESTIMATED BY CLASS

| | | | |
|--|---------------------|-------------------|-------------------|
| Licenses and Permits | \$ 818,846 | \$ 646,967 | \$ 1,465,813 |
| Taxes | (711,037) | | (711,037) |
| Investment Earnings | | | |
| Fines, Forfeits and Settlements | | | (12,882) |
| Miscellaneous | 1,295,914 | | 1,295,914 |
| | 238 | 23,606 | 23,844 |
| Federal | | (1,275,038) | (1,275,038) |
| Budgeted Revenues & Transfers-In Over (Under) Estimated | \$ 1,403,961 | \$ 646,967 | \$ 786,614 |

This schedule is prepared from the Statewide Accounting, Budgeting, and Human Resources System (SABHRS) without adjustment. Additional information is provided in the notes to the financial schedules beginning on page A-11.

STATE AUDITOR'S OFFICE
SCHEDULE OF TOTAL REVENUES & TRANSFERS-IN
FOR THE FISCAL YEAR ENDED JUNE 30, 2003

TOTAL REVENUES & TRANSFERS-IN BY CLASS

| | General Fund | State Special Revenue Fund | Federal Special Revenue Fund | Total |
|---|---------------------|----------------------------|------------------------------|----------------------|
| Licenses and Permits | \$ 6,024,618 | \$ 6,355,203 | | \$ 12,379,821 |
| Taxes | 49,868,318 | | | 49,868,318 |
| Investment Earnings | 143,256 | | 14,402 | 14,402 |
| Fines, Forfeits and Settlements | 957 | 12,900 | 50,256 | 143,256 |
| Miscellaneous | 2,036,200 | | | 64,113 |
| Other Financing Sources | | | 12,464,355 | 2,036,200 |
| Federal | | | | 12,464,355 |
| Total Revenues & Transfers-In | <u>58,073,349</u> | <u>6,368,103</u> | <u>12,529,013</u> | <u>76,970,465</u> |
| Less: Nonbudgeted Revenues & Transfers-In | | | | |
| Prior Year Revenues & Transfers-In Adjustments | 2,037,286 | 19,754 | 50,256 | 2,107,296 |
| | (58,439) | (10,484) | | (68,923) |
| Actual Budgeted Revenues & Transfers-In | <u>56,094,502</u> | <u>6,358,833</u> | <u>12,478,757</u> | <u>74,932,092</u> |
| Estimated Revenues & Transfers-In | 49,338,380 | 5,514,161 | 8,352,000 | 63,204,541 |
| Budgeted Revenues & Transfers-In Over (Under) Estimated | <u>\$ 6,756,122</u> | <u>\$ 844,672</u> | <u>\$ 4,126,757</u> | <u>\$ 11,727,551</u> |

BUDGETED REVENUES & TRANSFERS-IN OVER (UNDER) ESTIMATED BY CLASS

| | | | |
|---|---------------------|-------------------|----------------------|
| Licenses and Permits | \$ 140,177 | \$ 844,672 | \$ 984,849 |
| Taxes | 6,529,105 | | 6,529,105 |
| Investment Earnings | | | (87,598) |
| Fines, Forfeits and Settlements | 88,256 | (87,598) | 88,256 |
| Miscellaneous | (1,416) | | (1,416) |
| Federal | | | 4,214,355 |
| Budgeted Revenues & Transfers-In Over (Under) Estimated | <u>\$ 6,756,122</u> | <u>\$ 844,672</u> | <u>\$ 11,727,551</u> |

This schedule is prepared from the Statewide Accounting, Budgeting, and Human Resources System (SABHRS) without adjustment. Additional information is provided in the notes to the financial schedules beginning on page A-11.

STATE AUDITOR'S OFFICE
SCHEDULE OF TOTAL EXPENDITURES & TRANSFERS-OUT
FOR THE FISCAL YEAR ENDED JUNE 30, 2004

| PROGRAM (ORG) EXPENDITURES & TRANSFERS-OUT | CENTRAL MANAGEMENT | FOREST RESERVE & FPGA TO COUNTIES | INSURANCE | LOCAL ASSISTANCE TO COUNTIES | SECURITIES | TOTAL |
|---|-----------------------|--------------------------------------|--------------|---------------------------------|--------------|---------------|
| Personal Services | | | | | | |
| Salaries | \$ 344,784 | | \$ 1,655,878 | | \$ 407,107 | \$ 2,407,769 |
| Employee Benefits | 92,559 | | 478,689 | | 123,577 | 694,825 |
| Total | 437,343 | | 2,134,567 | | 530,684 | 3,102,594 |
| Operating Expenses | | | | | | |
| Other Services | 35,926 | | 136,557 | | 57,215 | 229,698 |
| Supplies & Materials | 15,548 | | 108,501 | | 18,900 | 140,949 |
| Communications | 10,263 | | 101,919 | | 16,466 | 128,648 |
| Travel | 6,591 | | 43,055 | | 18,605 | 68,251 |
| Rent | 27,910 | | 142,556 | | 37,472 | 207,938 |
| Repair & Maintenance | (84) | | (239) | | 38 | (285) |
| Other Expenses | 2,886 | | 26,366 | | 4,628 | 33,880 |
| Total | 99,040 | | 556,715 | | 153,324 | 809,079 |
| Local Assistance | | | | | | |
| From Federal Sources | | \$ 12,426,043 | | | | 12,426,043 |
| From Other Income Sources | | | | \$ 15,621,310 | | 15,621,310 |
| Total | | 12,426,043 | | 15,621,310 | | 28,047,353 |
| Grants | | | | | | |
| From Federal Sources | | | 573,215 | | | 573,215 |
| Total | | | 573,215 | | | 573,215 |
| Transfers | | | | | | |
| Accounting Entity Transfers | | | | | 2,113,000 | 2,113,000 |
| Total | | | | | 2,113,000 | 2,113,000 |
| Total Expenditures & Transfers-Out | \$ 536,383 | \$ 12,426,043 | \$ 3,264,497 | \$ 15,621,310 | \$ 2,797,008 | \$ 34,645,241 |
| EXPENDITURES & TRANSFERS-OUT BY FUND | | | | | | |
| General Fund | | | | | | |
| State Special Revenue Fund | \$ 536,383 | | \$ 3,264,497 | \$ 15,621,310 | \$ 2,776,679 | \$ 15,621,310 |
| Federal Special Revenue Fund | | 12,426,043 | | | 20,329 | 6,577,559 |
| Total Expenditures & Transfers-Out | 536,383 | 12,426,043 | 3,264,497 | 15,621,310 | 2,797,008 | 12,446,372 |
| | | | | | | 34,645,241 |
| Less Nonbudgeted Expenditures & Transfers-Out | | | 6,659 | | 2,123,050 | 2,129,709 |
| Prior Year Expenditures & Transfers-Out Adjustments | (619) | | 3,793 | | (2,261) | 913 |
| Actual Budgeted Expenditures & Transfers-Out | 537,002 | 12,426,043 | 3,254,045 | 15,621,310 | 676,219 | 32,514,619 |
| Budget Authority | 553,328 | 13,750,000 | 3,638,876 | 15,644,699 | 788,448 | 34,375,351 |
| Unspent Budget Authority | 16,326 | 1,323,957 | 384,831 | 23,389 | 112,229 | 1,860,732 |
| UNSPENT BUDGET AUTHORITY BY FUND | | | | | | |
| General Fund | | | | | | |
| State Special Revenue Fund | \$ 16,326 | | \$ 384,831 | \$ 23,389 | \$ 420 | \$ 23,809 |
| Federal Special Revenue Fund | | 1,323,957 | | | 91,501 | 492,658 |
| Unspent Budget Authority | 16,326 | 1,323,957 | 384,831 | 23,389 | 20,308 | 1,344,265 |
| | | | | | 112,229 | 1,860,732 |

This schedule is prepared from the Statewide Accounting, Budgeting, and Human Resources System (SABHRS) without adjustment. Additional information is provided in the notes to the financial schedules beginning on page A-11.

STATE AUDITOR'S OFFICE
SCHEDULE OF TOTAL EXPENDITURES & TRANSFERS-OUT
FOR THE FISCAL YEAR ENDED JUNE 30, 2003

| PROGRAM (ORG) EXPENDITURES & TRANSFERS-OUT | CENTRAL MANAGEMENT | FOREST RESERVE & FPGA TO COUNTIES | INSURANCE | LOCAL ASSISTANCE TO COUNTIES | SECURITIES | TOTAL |
|---|-----------------------|--------------------------------------|---------------------|---------------------------------|---------------------|----------------------|
| Personal Services | | | | | | |
| Salaries | \$ 313,737 | | \$ 1,634,919 | | \$ 379,472 | \$ 2,328,128 |
| Employee Benefits | 76,158 | | 438,217 | | 108,679 | 623,054 |
| Total | <u>389,895</u> | | <u>2,073,136</u> | | <u>488,151</u> | <u>2,951,182</u> |
| Operating Expenses | | | | | | |
| Other Services | 35,655 | | 206,285 | | 99,130 | 341,070 |
| Supplies & Materials | 12,520 | | 47,867 | | 12,828 | 73,215 |
| Communications | 9,923 | | 109,118 | | 16,402 | 135,443 |
| Travel | 13,839 | | 49,736 | | 19,970 | 83,545 |
| Rent | 21,272 | | 118,697 | | 31,037 | 171,006 |
| Repair & Maintenance | 718 | | 1,472 | | 150 | 2,340 |
| Other Expenses | 17,664 | | 43,649 | | 10,574 | 71,887 |
| Total | <u>111,591</u> | | <u>576,824</u> | | <u>190,091</u> | <u>878,506</u> |
| Local Assistance | | | | | | |
| From Federal Sources | | 12,478,757 | | 14,572,298 | | 12,478,757 |
| From Other Income Sources | | | | 14,572,298 | | 14,572,298 |
| Total | | <u>12,478,757</u> | | | | <u>27,051,055</u> |
| Transfers | | | | | | |
| Accounting Entity Transfers | | | | | 2,036,200 | 2,036,200 |
| Total | | | | | <u>2,036,200</u> | <u>2,036,200</u> |
| Total Expenditures & Transfers-Out | \$ <u>501,486</u> | \$ <u>12,478,757</u> | \$ <u>2,649,960</u> | \$ <u>14,572,298</u> | \$ <u>2,714,442</u> | \$ <u>32,916,943</u> |
| EXPENDITURES & TRANSFERS-OUT BY FUND | | | | | | |
| General Fund | | | | | | |
| State Special Revenue Fund | \$ 501,486 | | \$ 2,649,960 | \$ 14,572,298 | \$ 322,119 | \$ 14,894,417 |
| Federal Special Revenue Fund | | 12,478,757 | | | 2,349,283 | 5,500,729 |
| Total Expenditures & Transfers-Out | <u>501,486</u> | <u>12,478,757</u> | <u>2,649,960</u> | <u>14,572,298</u> | <u>43,040</u> | <u>12,521,797</u> |
| Less: Nonbudgeted Expenditures & Transfers-Out | | | 2,082 | | 2,714,442 | 32,916,943 |
| Prior Year Expenditures & Transfers-Out Adjustments | 88 | | (3,858) | | 2,047,173 | 2,049,255 |
| Actual Budgeted Expenditures & Transfers-Out | <u>501,398</u> | <u>12,478,757</u> | <u>2,651,736</u> | <u>14,572,298</u> | <u>220</u> | <u>(3,550)</u> |
| Budget Authority | 540,195 | 12,490,000 | 2,845,123 | 14,745,592 | 667,049 | 30,871,238 |
| Unspent Budget Authority | <u>38,797</u> | <u>11,243</u> | <u>193,387</u> | <u>173,294</u> | <u>709,587</u> | <u>31,330,497</u> |
| UNSPENT BUDGET AUTHORITY BY FUND | | | | | | |
| General Fund | | | | | | |
| State Special Revenue Fund | \$ 38,797 | | \$ 193,387 | \$ 173,294 | \$ 1,402 | \$ 174,696 |
| Federal Special Revenue Fund | | 11,243 | | | 20,462 | 252,646 |
| Unspent Budget Authority | <u>38,797</u> | <u>11,243</u> | <u>193,387</u> | <u>173,294</u> | <u>20,674</u> | <u>31,917</u> |
| | | | | | <u>42,538</u> | <u>459,259</u> |

This schedule is prepared from the Statewide Accounting, Budgeting, and Human Resources System (SABHRS) without adjustment. Additional information is provided in the notes to the financial schedules beginning on page A-11.

State Auditor's Office

Notes to the Financial Schedules

For the Two Fiscal Years Ended June 30, 2004

1. Summary of Significant Accounting Policies

Basis of Accounting

The office uses the modified accrual basis of accounting, as defined by state accounting policy, for its Governmental fund category (General, State Special Revenue and Federal Special Revenue Funds). In applying the modified accrual basis, the office records:

Revenues when it receives cash or when receipts are measurable and available to pay current period liabilities.

Expenditures for valid obligations when the office incurs the related liability and it is measurable, with the exception of the cost of employees' annual and sick leave. State accounting policy requires the office to record the cost of employees' annual leave and sick leave when used or paid.

The office uses accrual basis accounting for its Fiduciary fund category (Agency Fund). Under the accrual basis, as defined by state accounting policy, the office records revenues in the accounting period earned, when measurable, and records expenses in the period incurred, when measurable.

Expenditures and expenses may include: entire budgeted service contracts even though the office receives the services in a subsequent fiscal year; goods ordered with a purchase order before fiscal year-end, but not received as of fiscal year-end; and equipment ordered with a purchase order before fiscal year-end.

Basis of Presentation

The financial schedule format is in accordance with the policy of the Legislative Audit Committee. The financial schedules are prepared from the transactions posted to the state's accounting system without adjustment.

The 2001 Legislature modified the fund structure established in section 17-2-102, MCA, to implement the changes made to generally

Notes to the Financial Schedules

accepted accounting principles (GAAP) by Governmental Accounting Standards Board (GASB) Statement 34. These changes were effective July 1, 2001. Office accounts are organized in funds according to state law applicable at the time transactions were recorded. The office uses the following funds:

Governmental Fund Category

General Fund - to account for all financial resources except those required to be accounted for in another fund. General Fund includes operations for securities in fiscal year 2002-03, and police officer and firefighter retirement transfers made to counties for fiscal years 2002-03 and 2003-04. Securities operations were funded through state special revenues in fiscal year 2004.

State Special Revenue Fund - to account for proceeds of specific revenue sources legally restricted to expenditures for specific purposes. Office State Special Revenue Funds include Insurance and Security Division activity such as the securities and insurance examination fees, insurance industry continuing education programs, and securities portfolio registrations.

Federal Special Revenue Fund - to account for federal funds received by the department. Office Federal Special Revenue Funds include the receipt and disbursement of federal forest reserve funds to Montana counties.

Fiduciary Fund Category

Agency Fund – to account for resources held by the state in a custodial capacity. The office's Agency Fund accounts for cash and securities required to be held in trust by the office for insurance companies licensed in Montana.

2. General Fund Balance (negative balances)

The negative fund balance in the General Fund does not indicate overspent appropriation authority. Each agency has authority to pay obligations from the statewide General Fund within its appropriation limits. Each agency expends cash or other assets from the statewide fund when it pays General Fund obligations. The office's outstanding liabilities exceed the assets the agency has placed in the fund, resulting in negative ending General Fund balances for each of the two fiscal years ended June 30, 2004 and June 30, 2003.

3. Direct Entries to Fund Balance

Direct entries to fund balances in the General and State Special Revenue funds include entries generated by SABHRS to reflect the flow of resources within individual funds shared by separate agencies.

4. Property Held in Trust

As described in the Fiduciary Fund Category under Note 1, the State Auditor's Office maintains cash and securities required to be held in trust by the office for insurance companies licensed in Montana. During fiscal year 2002-03, the office did not record entries to correct errors made to property held in trust accounts, and as a result of a clerical error, recorded additions and reductions to property held in trust for fiscal year 2002-03 in fiscal year 2003-04. As a result, the ending property held in trust balance on the Schedule of Changes in Fund Balances and Property Held in Trust is overstated by \$121,324 for fiscal year 2002-03 and overstated by \$33,208 for fiscal year 2003-04.

State Auditor's Office Response

MONTANA STATE AUDITOR

JOHN MORRISON
STATE AUDITOR



COMMISSIONER OF INSURANCE
COMMISSIONER OF SECURITIES

October 6, 2004

RECEIVED

OCT 07 2004

LEGISLATIVE AUDIT DIV.

Mr. Scott Seacat
Legislative Auditor
Office of the Legislative Auditor
State Capitol
P.O. Box 201705
Helena, MT 59620-1705

Dear Mr. Seacat:

We have reviewed your financial compliance audit for the two fiscal years ending June 30, 2004. Our response to each audit recommendation follows:

Recommendation #1:

We recommend the office comply with state law by only appointing examiners that do not have a conflict of interest with the insurance company being examined.

Agency Response:

We concur. Our office had begun the RFP process to contract with a pool of contract examiners before the financial audit began. This RFP process has been completed and the office now has a pool of examiners to contract. The examiner in question will not be used to examine any company where a conflict of interest occurs.

At the time the conflict existed no other examiner was available. The agency recognized the conflict and instituted increased supervision of the audit by office staff. The RFP process began in July of 2004 and was completed by September 2004. Contracts are now being negotiated with the qualified applicants to create a pool of financial examiners we can draw from in the future. The RFP process was initiated to avoid future conflicts.

Recommendation #2:

We recommend the office develop procedures to comply with the custodial deposit assignment requirements as specified in state law.

Agency Response:

We concur. The Insurance Examination Bureau has developed and adopted a policy to insure that all deposits have an assignment in place with the office for each deposit held in trust. This policy also includes steps to insure that a new assignment will be in place before a security deposit held by the office is released.

Recommendation #3:

We recommend the office perform additional supervisory review of infrequent and year-end accounting transactions to improve the accuracy of the accounting records.

Agency Response:

We concur. The office is in the process of implementing fiscal year-end procedures that will focus on the less frequent transactions that occur within the office. These procedures will be in place for fiscal year 2005. The procedures will include the transactions and the review process for fiscal year-end transactions and the less frequent transactions that occur within the office.

Recommendation #4:

We recommend the office work with the Department of Administration to record the financial activity and financial position related to the Surplus Lines Advisory Organization in the state's accounting records.

Agency Response:

We concur. The office is the process of working with the Department of Administration to determine what steps need to be taken in recording the activities of the Surplus Lines Advisory Organization in the state's accounting records.

Recommendation #5:

We recommend the office apportion forest reserve funds within 30 days of receiving final payment from the federal government, as required by state law.

Agency Response:

We concur. The office is in the process of implementing fiscal year-end procedures that will focus on the less frequent transactions that occur within the office. These procedures will be in place for fiscal year 2005. The procedures will include the transactions and the review process for fiscal year-end transactions and the less frequent transactions that occur within the office.

Recommendation #6:

We recommend the office follow up on local government audit findings communicated to the office, as required by federal law.

Agency Response:

We do not concur. Our office is funded by the operations of the Insurance and Securities Departments through fees assessed these industries. 33-2-708, MCA provides the commissioner of insurance to collect fees from insurance companies doing business in the state of Montana. 30-10-209, MCA provides the commissioner of securities to collect fees from the securities industry doing business in the state of Montana. These fees provide the funding for the operations of this office and are dedicated revenues sources.

This office does not have a general fund appropriation to cover the costs of current efforts. Follow up on the local government audit findings related to the federal forest reserve would require further diversion of other dedicated revenues.

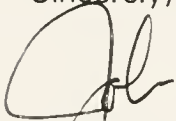
The forest reserve fund is a pass through from the federal government to counties. 17-3-213, MCA provides the allocation of these funds, 66 2/3% to the general road funds and 33 1/3% to countywide school levies. The agency does not have statutory authority to withhold funds, require their repayment, or require corrective action if counties have audit exceptions. Therefore, audit follow up by the agency serves no useful purpose.

The federal forest reserve function should be transferred to an agency that has a more vested interest in these funds and one that has existing statutory authority to require local government compliance with audit exceptions. We would work with the Governor's budget office and the legislative branch to transfer this function to another agency.

Mr. Scott Seacat
Page 4
October 6, 2004

I would like to thank your staff for their time and effort during this audit. They were very professional and helpful addressing the issues that concerned my staff and pointing out areas that need improvement.

Sincerely,

A handwritten signature in black ink, appearing to be 'John Morrison', written over a large, faint circular stamp.

John Morrison
State Auditor

JM/jhn

